TAX FOR THE Owner-Manager

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# Section 160 and Transfers Between Spouses: Distinguishing Moral from Legal Obligations

In *Brown v. The Queen* (2020 TCC 45), the TCC considered whether transfers made by Mr. Levoy to his spouse, Ms. Brown, were given for valid consideration or were made merely in respect of non-enforceable moral obligations, and consequently whether such transfers triggered the application of section 160.

The facts were relatively simple. Ms. Brown received notices of assessment dated September 17, 2010 in respect of transfers made to her by Mr. Levoy in 2006, 2007, and 2008 in the amounts of $98,063, $51,776, and $3,348, respectively. At the time of the transfers, Mr. Levoy owed tax in amounts far exceeding the amounts transferred to Ms. Brown. Mr. Levoy's tax debts were the result of an unfortunate set of personal circumstances arising from his ownership (through a corporation) and management of a resort in Ontario. A call centre at the resort was rented out to a third party, which used it to conduct criminal activities. Mr. Levoy, who was unaware of the criminal activities, was criminally charged in Canada in 2002, and subsequently in the United States.

An external audit firm performed an audit on the operations of the resort in the wake of the criminal charges. On the audit firm's advice, Mr. Levoy made a voluntary disclosure to the CRA in 2002 for taxes owing that related to preceding taxation years. In 2006, the CRA informed Mr. Levoy that his voluntary disclosure had not been accepted.

As a result of the ongoing criminal charges, all of Mr. Levoy's bank accounts were shut down. Even after the criminal charges in the United States and Canada were dropped in 2004 and 2005, Mr. Levoy remained unable to open a new bank account.

In 2005, to improve the operation of the resort, an external provider was hired to handle payroll responsibilities at the resort. Mr. Levoy opted to receive his salary by cheque rather than direct deposit because he did not have a bank account. However, Mr. Levoy's accountant suggested that Ms. Brown deposit the salary cheques into her bank account and then pay Mr. Levoy's monthly credit card charges. Despite her initial reluctance, Ms. Brown agreed to this arrangement.

Ms. Brown maintained accounting records in respect of the relevant transfers and credit card payments, as did Mr. Levoy. If Mr. Levoy's deposits exceeded his credit card bill for a month, Ms. Brown would roll over the excess deposits and apply them to the credit card bills in subsequent periods.

As a result of his financial difficulties, Mr. Levoy made a proposal in bankruptcy that was accepted by his creditors; the proposal included payments to the CRA of $171,300. As of July 2016, Mr. Levoy was no longer in debt to the CRA.

Two questions were before the TCC: (1) Had Ms. Brown given adequate consideration pursuant to paragraph 160(1)(e) such that the impugned transfers did not attract the application of section 160? (2) What was the effect of the subsequent successful bankruptcy proposal on the impugned transfers?

With respect to the first question, since three of the four elements of the test set out in *Canada v. Livingston* (2008 FCA 89) (which is a judicial restatement of the statutory applicability of section 160) were satisfied, the only question for the court to consider was the fourth element—namely, whether Ms. Brown had given adequate consideration to Mr. Levoy in respect of the transfers made by him to her.

The Crown cited *Livingston, Raphael v. Canada* (2002 FCA 23), and *Pickard v. The Queen* (2010 TCC 535) in support of the assertion that Ms. Brown's obligation was moral and not legal, and argued that section 160 therefore applied in respect of the relevant transfers. However, the court distinguished the present case from the cases cited by the Crown. The court held that there was an enforceable contract between Mr. Levoy and Ms. Brown pursuant to which Ms. Brown undertook to deposit Mr. Levoy's paycheques in her personal bank account and in return committed to pay Mr. Levoy's credit card bills pursuant to his direction. The evidence showed that had Ms. Brown failed to discharge this obligation, Mr. Levoy could have sued

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her to enforce the action. Thus, the obligation was a legal and not a moral one.

The TCC noted that in *Livingston* (where the court had reached a different result in similar circumstances), an intention to defraud the CRA was present. Such an intention was not a requirement to satisfy section 160, but it was a factor that the FCA in *Livingston* considered when assessing the adequacy of the consideration. The TCC distinguished the present case from *Livingston* on the basis that, among other reasons, no intention to thwart the collection efforts of the CRA was present because Ms. Brown had agreed to the arrangement with Mr. Levoy before the failure of his voluntary disclosure and while she was unaware that Mr. Levoy was a tax debtor. The court also distinguished the present case from *Pickard* for a number of reasons, including *Pickard*'s lack of corroborating testimony and accounting evidence, which Ms. Brown was able to furnish in the present case.

On the basis that there was a legally enforceable agreement in place between Ms. Brown and Mr. Levoy, the TCC held that subsection 160(1) did not apply to the impugned transfers, and it allowed the appeal. Because this holding rendered the effect of the bankruptcy proposal moot, the court declined to consider that question.

This case serves as a practical warning to tax practitioners regarding transfers between spouses. To the extent that it is intended that a transfer between spouses not attract the application of section 160 because the spouse accepting the transfer will give full consideration in the form of assuming a corresponding obligation to pay the expenses of the transferring spouse, that intention should be reinforced with written documentation. Appropriate documentary evidence, supplemented by accounting showing that the obligation was properly discharged, will reduce the likelihood that any such transfers will be impugned under section 160.

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## TOSI: "Provision of Services" in a Digital Age

In a technical interpretation (CRA document no. 2019-0833181E5, March 15, 2020), the CRA provided general comments on when the sale or licensing of digital products can result in income from the provision of services for the purposes of the tax on split income (TOSI) rules. The CRA concluded that payments received for the right to download a digital product, which traditionally would have been sold as tangible property, will generally result in income from the sale of an intangible property rather than from the provision of services. However, the CRA also said that the determination of whether the sale or licensing of digital products results in income from the provision of services requires a complete understanding of the legal relationship between the vendor and the customer, including the digital product's terms of use.

The TI included three illustrative examples of related activities that will generally result in income from the provision of services. This guidance may help shareholders of corporations that carry on such activities to determine whether they qualify for the "excluded shares" exemption from TOSI. A condition of the exemption is that less than 90 percent of the corporation's business income is from the provision of services.

Generally, when a specified individual receives split income, that amount is subject to TOSI (that is, it is taxed at the top marginal personal income tax rate), unless the income is an "excluded amount." For individuals who are 25 or older, an excluded amount includes income from, or taxable capital gains from the disposition of, "excluded shares" held by the individual. Excluded shares are shares that are owned by a specified individual and meet a number of conditions set out in the definition in subsection 120.4(1). One such condition is that less than 90 percent of the corporation's business income for the last taxation year that ends at or before that particular time was derived from the provision of services.

In the TI, the CRA considered whether income that a corporation derives from the business of producing and selling training videos as digital downloads from its website would be considered income from the provision of services for the purposes of the excluded-shares definition. The CRA concluded that there was not enough information to determine whether income from this particular business was from the provision of services. However, the CRA provided general comments to help with the determination of whether income from the sale or licensing of digital products may be from the provision of services.

The CRA said that it is prepared to accept that payments for the right to download a digital product that traditionally would have been sold to the customer as a tangible property will generally be treated as the sale of intangible property and not as a provision of services, unless the facts and circumstances dictate otherwise.

The CRA distinguished business income generated by these payments from other payments that the business may generally receive for the provision of services, such as

- payments obtained as consideration for after-sales service,
- payments for services rendered by a supplier under a guarantee, and
- payments for pure technical assistance.

The CRA also noted that when a digital product is delivered to a customer's computer, the characterization of the payment requires a complete understanding of (1) the agreement

between the supplier and the customer, and (2) whether the legal substance of the arrangement is for work or work and materials (that is, a service) or for intangible property.

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## Transfer-Pricing Recharacterization Rules Considered

*Canada v. Cameco Corporation* (2020 FCA 112) marks another watershed moment in Canadian transfer pricing. At issue were profits earned by Cameco Canada's European subsidiaries in Luxembourg and Switzerland (collectively, "Cameco Europe"). Cameco Europe generated profits by purchasing uranium for resale from Cameco Canada and from third parties Tenex and Urenco. Cameco Canada negotiated the Tenex and Urenco contracts that were signed by Cameco Europe, and it ultimately guaranteed Cameco Europe's obligations in its dealings with these third-party uranium suppliers. Another of Cameco Canada's subsidiaries, Cameco US, dealt with end customers and purchased uranium from Cameco Europe for resale to the end customers at a 2 percent discount from the sales price.

The contracts governing the purchase of uranium by Cameco Europe from these parties were executed when uranium prices were relatively low. During the taxation years under appeal (2003, 2005, and 2006), Cameco Europe earned significant profits due to substantial increases in uranium prices, which the minister contended should be included in Cameco Canada's income. At the TCC (2019 TCC 92), the minister relied on three arguments to support her reassessments: (1) that the related-party arrangements were a sham, (2) that the recharacterization rules of paragraphs 247(2)(b) and (d) applied, and (3) that the more traditional transfer-pricing rules of paragraphs of 247(2)(a) and (c) applied. All three arguments were unsuccessful.

In the appeal to the FCA, the minister argued that Owen J had erred in his interpretation of the recharacterization rules of paragraphs 247(2)(b) and (d) and, alternatively, that he had erred in his interpretation of the traditional transfer-pricing rules of paragraphs 247(2)(a) and (c). The TCC's decision was the first judgment to examine the recharacterization rules of paragraphs 247(2)(b) and (d), and the FCA's decision is the first instance of a higher court examining those rules.

The traditional transfer-pricing rules in paragraphs 247(2)(a) and (c) allow the minister to make an adjustment to the quantum of a related-party transaction where the terms and conditions of the transaction, including the price, differ from those that would have been made between parties dealing at arm's length. These traditional rules respect the form of the transaction as presented by a taxpayer and seek to adjust the quantum of the transaction to rectify cases only when the revenue earned by a taxpayer or the expense incurred by a taxpayer on the transaction is inconsistent with arm's-length pricing.

Although the minister put forth an alternative argument referencing the traditional transfer-pricing rules of paragraphs 247(2)(a) and (c), the minister's appeal effectively relied on the argument that the traditional rules, which respect the form of the related-party transaction, were insufficient in this case. The FCA noted that during the hearings the minister was particularly focused on the profits realized by Cameco Europe during the taxation years under appeal. Those profits were earned by buying and selling uranium, in some cases from third parties in circumstances where Cameco Canada's involvement was limited to guaranteeing Cameco Europe's payment obligations to its suppliers. Reallocating the profits earned by Cameco Europe in their entirety to Cameco Canada would have required a recharacterization of the related-party transaction.

The recharacterization rules of paragraphs 247(2)(b) and (d) allow the minister to disregard the form of the related-party transaction as presented and instead substitute a separate notional transaction. For an adjustment under the recharacterization rules to apply, subparagraphs 247(2)(b)(i) and (ii) require that two conditions be met:

1) the related-party transaction would not have been entered into by arm's-length parties, and
2) the related-party transaction was entered into primarily for no bona fide purpose other than to obtain a tax benefit.

The minister argued in her appeal that Cameco Canada would not have entered into any of the transactions that it had entered into with Cameco Europe with arm's-length parties. Specifically, the minister argued that in arm's-length circumstances, Cameco Canada would not have engaged Cameco Europe at all. Instead, Cameco Canada would have entered into the contracts directly with the third-party uranium suppliers and would have sold uranium directly to Cameco US. This alternative arrangement would have removed Cameco Europe from the supply chain, and any profits earned by Cameco Europe would have instead been earned by Cameco Canada.

Although this argument related to the facts and circumstances of Cameco Corporation and its dealings with its related parties, such an argument, had it been successful, could have had broad implications for Canadian entrepreneurs looking to expand internationally. Specifically, under a tax regime governed by the broad interpretation of the recharacterization rules put forth by the minister, a Canadian entrepreneur would always have to consider whether a subsidiary was entitled to any profit, since the minister could argue that a Canadian-headquartered business would not be willing to relinquish potential profits in arm's-length circumstances. Such a regime could ultimately hamper the ability of Canadian entrepreneurs

to grow their businesses internationally. In addition, that interpretation would likely be inconsistent with the interpretations of tax regimes in other jurisdictions, creating a potential administrative burden to resolve the inconsistency and the resulting double taxation.

However, the minister was unsuccessful in her appeal to the FCA. The FCA held that the interpretation of subparagraph 247(2)(b)(i) was not a question of whether the specific taxpayer and its foreign related party would have entered into a transaction in arm's-length circumstances, but a question of whether any arm's-length parties would enter into the transaction. Only if it can reasonably be concluded that no arm's-length parties would have entered into the transaction under any terms and conditions will subparagraph 247(2)(b)(i) apply. Because the minister's appeal failed the first of the two conditions of paragraph 247(2)(b), the FCA did not examine the second requirement—that the transaction be reasonably considered to have been primarily entered into for no bona fide purpose other than to obtain a tax benefit.

With such a high bar set by the FCA in its interpretation of subparagraph 247(2)(b)(i), Canadian taxpayers can take some comfort in knowing that their related-party transactions can be recharacterized only in specific and rare circumstances, which was the original intention of the legislation. The FCA reaffirmed the TCC's decision that subparagraph 247(2)(b)(i) does not apply to a related-party transaction that is commercially rational in the circumstances. A transaction that is unique, or one for which evidence of arm's-length parties entering into sufficiently similar transactions is not readily available, does not alone deem subparagraph 247(2)(b)(i) to apply. For this reason, Canadian taxpayers can focus on ensuring that their related-party transactions are consistent with arm's-length terms and conditions, including the price.

The minister's alternative argument in the FCA—that the traditional transfer-pricing rules of paragraphs 247(2)(a) and (c) applied—was also unsuccessful. The minister argued that the Tenex and Urenco contracts negotiated by Cameco Canada and signed by Cameco Europe were valuable on their date of signing, and for this reason Cameco Canada was entitled to compensation for negotiating the contracts. At the TCC, Owen J examined the contracts and determined that at the time they were signed they had no value. The value of the contracts increased over time as the market price of uranium increased, something that was far from certain. The minister had not appealed the factual findings of the TCC, only the interpretation of the relevant provisions of the Act, and therefore the FCA dismissed this alternative argument.

Although the FCA did not overrule the TCC's findings, an important takeaway message for Canadian entrepreneurs is that when a Canadian parent company is establishing a foreign subsidiary, it is important to consider whether something of value is being transferred to the subsidiary and whether the Canadian parent should be compensated. Furthermore, the traditional transfer-pricing rules of paragraphs 247(2)(a) and (c) must be examined on the basis of the circumstances at the time the transaction was entered into and not with the benefit of hindsight. This point illustrates the value of determining the appropriate terms and conditions for related-party transactions at the outset. As long as these terms and conditions are commercially rational and consistent with arm's-length terms and conditions, then certain outcomes, such as a loss by a Canadian taxpayer or a substantial profit in a foreign related party, are not inconsistent with the transfer-pricing laws of Canada.

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## Corporate Partnership May Avoid the Paragraph 125(5.1)(b) Grind

The 2018 federal budget added paragraph (b) to subsection 125(5.1) to penalize certain CCPCs that earn excessive investment income. Generally, the paragraph modifies the calculation of the small business deduction (SBD) limit available to a group of associated corporations based on the adjusted aggregate investment income (AAII) of the associated group, which is defined in subsections 125(7) and 129(4) and includes passive investment income such as interest, portfolio dividends, and certain capital gains. In particular, the SBD limit is reduced by $5 for every $1 of AAII of the associated group of corporations over $50,000 in the previous taxation year. Therefore, if the AAII exceeds $50,000, the corporations in the group with the active business income will generally be subject to a higher effective corporate income tax rate due to the lower SBD limit available to them.

Consider, for example, the following common structure (illustrated in figure 1) in which two spouses, both residents of Canada, own two CCPCs. One CCPC (Opco) is wholly owned by Mr. X, and the other CCPC (Investco) is owned 49 percent by Ms. Y and 51 percent by Mr. X. Opco is engaged in an active business carried on in Canada that generates more than $500,000 of taxable income on an annual basis. Investco has an investment portfolio worth $2 million and earns $90,000 in investment income annually. Assume that the $90,000 of investment income should be fully included in Investco's AAII.

In determining whether paragraph 125(5.1)(b) will apply in these circumstances, the associated-corporation rules in section 256 should be examined. Opco and Investco are associated pursuant to paragraph 256(1)(b) because Mr. X controls both corporations. Therefore, since the AAII of Investco exceeds $50,000 (and assuming that there is no further SBD limit

**Figure 1**

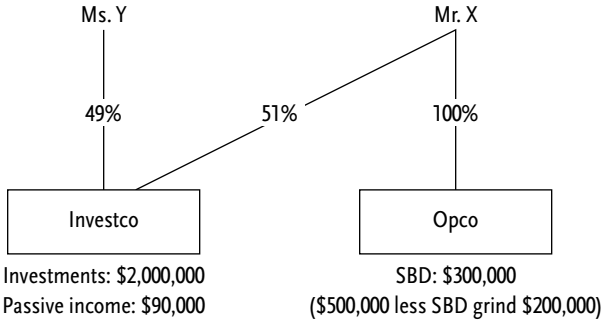
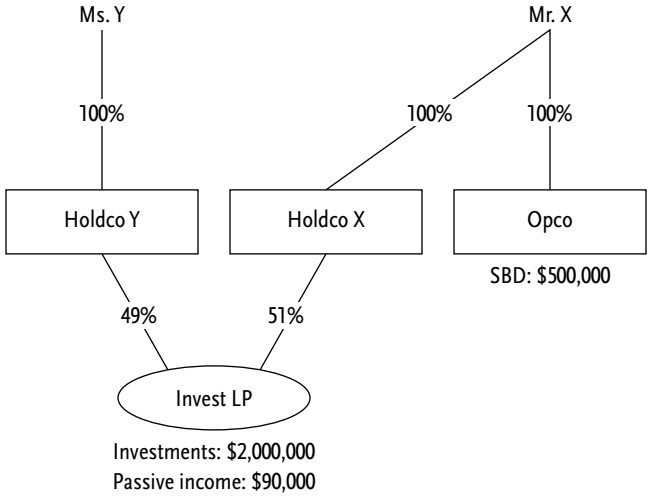



**Figure 2**




reduction because the taxable capital employed in Canada exceeds $10 million), the SBD limit available to the associated group will be reduced by the amount commonly referred to as the SBD grind, calculated as follows (according to the formula in paragraph 125(5.1)(b)):

SBD limit reduction = SBD limit of $500,000/$500,000 × 5 × (AAII of $90,000 − $50,000) = $200,000

Thus, Opco will have an SBD limit of $300,000 (the $500,000 limit less the $200,000 reduction), and any income in excess of the limit will be taxed at a higher corporate tax rate.

The structure could be modified such that Ms. Y and Mr. X will have the same economic interests in the $2 million investment portfolio and Opco while preserving the full SBD limit for Opco. In particular, instead of holding the investment portfolio in Investco, Ms. Y and Mr. X could hold the same portfolio in a partnership (Invest LP). The interests in the partnership would be held by Ms. Y and Mr. X through holding companies (Holdco X and Holdco Y, respectively). Figure 2 illustrates the modified structure (ignoring the general partner of Invest LP, which would hold a nominal interest).

The analysis of the application of paragraph 125(5.1)(b) begins with the analysis of the associated-corporation rules in section 256. As noted earlier, Holdco X and Opco are associated pursuant to paragraph 256(1)(b) because Mr. X controls both corporations. Holdco Y should not be associated with either Holdco X or Opco because there is no cross-ownership or common control (assuming that there is no de facto control of Holdco Y by Mr. X or of Holdco X or Opco by Ms. Y).

Because it has been determined that Opco and Holdco X are associated, we must consider the AAII of each of Holdco Y and Holdco X and how such amounts affect Opco's SBD limit. The investment income of Invest LP is allocated to Holdco Y and Holdco X pursuant to subsection 96(1); the character of the income allocated from Invest LP to Holdco Y and Holdco X is retained pursuant to paragraph 96(1)(f). Therefore, for the purposes of calculating the SBD grind in paragraph 125(5.1)(b), the AAII of Holdco X is $45,900 ($90,000 × 51%), and the AAII of Holdco Y is $44,100 ($90,000 × 49%). For the purposes of calculating the SBD grind, Opco should be required to include only the AAII of Holdco X in the formula in paragraph 125(5.1)(b) described above. The AAII of Holdco Y should not affect the SBD limit of Opco, because Opco and Holdco Y are not associated. Thus, Opco's SBD grind is based on AAII of $45,900. That amount does not exceed $50,000, and thus there is no SBD grind for Opco.

The modified structure may allow the preservation of Opco's SBD limit while maintaining the spouses' desired ownership of the investment portfolio. Note, however, that the modified structure will have higher maintenance costs due to the greater number of entities and certain complexities surrounding the partnership rules in the Act. Consideration should be given to the specific anti-avoidance provision in subsection 256(2.1), which may deem Holdco Y to be associated with Opco and Holdco X if one of the main reasons for the separate existence of those corporations was to reduce taxes payable. Finally, one must always keep GAAR in mind, since the CRA may seek to challenge the structure under that provision.

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## Trusts and Safe-Income Allocation

In a technical interpretation (CRA document no. 2019-0833061E5, January 27, 2020), the CRA says that trustees of a discretionary family trust cannot allocate the entire safe income on hand portion of a dividend received to a corporate beneficiary while paying the non-safe-income part of the same dividend to an individual beneficiary. In the CRA's view, the effect of a subsection 104(19) designation is that each trust beneficiary acquires a proportionate share of the safe income out of which the dividend is paid. (Jin Wen reviewed the TI in "Discretionary Trusts and Safe Income," *Canadian Tax Focus*, May 2020.) Is there a way in which the trustees can transfer all of the safe income to a corporate beneficiary? In this article, I explore the possible options after taking a closer look at the CRA's analysis in the TI.

The facts on which the CRA's view is based are straightforward. An operating corporation pays a $2,500 dividend to a discretionary family trust, $1,000 of which comes from its safe income on hand. The trustees distribute $1,500 of the dividend to a particular beneficiary (an individual) and $1,000 to a corporate beneficiary. The trustees want to exercise their discretion to allocate the entire safe-income portion of the dividend to the corporate beneficiary. The CRA stated that even though subsection 104 (19) deems this dividend to be a taxable dividend for the beneficiary, it "does not provide an ability to the trustees of a trust to adjust the safe income associated with a portion of the dividend that has been allocated to a particular beneficiary."

A similar problem can occur with eligible dividends. Subsection 89(14) provides that a corporation may designate a portion of a dividend paid as an eligible dividend. If a trust receives such a dividend, can the trustees allocate the eligible portion to one beneficiary while assigning the non-eligible portion to another? To my knowledge, the CRA has not publicly addressed this issue; however, it did acknowledge in *Income Tax Technical News* no. 41 (December 23, 2009) that an eligible dividend paid to a trust will still qualify as such in the hands of a beneficiary following a subsection 104(19) designation.

The wording of subsection 104(19) may suggest a way to optimize the safe-income allocation of dividends received by a trust. The designation is applicable to "[a] portion of a taxable dividend received by a trust, in a particular taxation year of the trust, on a share of the capital stock of a taxable Canadian corporation." The expression "dividend received . . . in a particular taxation year" indicates that the designation relates to the actual dividend paid in the year, on a cash basis. In the example given in the TI, if the first $1,000 of the dividend (corresponding to the safe income on hand) is paid in one taxation year and the other $1,500 is paid in the following taxation year, the trustees will file two subsection 104(19) designations, one for each dividend payment, in the two different tax returns of the trust, thus allowing the trustees to designate the first dividend to the corporate beneficiary. This will effectively pass all of the safe income to the corporate beneficiary. Even if the trust receives two dividends in the same taxation year, since subsection 104(19) refers to "[a] portion of a taxable dividend received . . . on a share," a separate designation seems possible for each dividend received on each share owned by the trust. The overall dividends received in a taxation year will theoretically be the subject not of a single designation but of as many designations as there are dividends received by the trust and payable to beneficiaries in the year. In the example, if a corporation declares and pays two dividends—first a dividend of $1,000, entirely covered by the safe income on hand, and later a dividend of $1,500, not covered by the safe income—it appears to be possible to allocate the first one and its adjunct safe income to a specific beneficiary (for example, a holding company) and the second one to a different beneficiary.

It would be helpful if the Act specifically allowed trustees to split the safe-income and the non-safe-income portion of a dividend in this way. That is exactly what paragraph 55(5)(f) does for section 55 purposes, but that paragraph does not apply to other provisions of the Act. Specifically, no such provision is applicable to subsection 104(19) as it might relate to an allocation of safe income or eligible dividends. In the absence of a specific provision, can the trust deed itself be worded in such a way that the trustees are given the power to make an allocation that will be effective for income tax purposes when they designate a dividend in favour of a specific beneficiary?

The CRA has refused on multiple occasions to allow the trustees to use their general discretionary powers under the trust deed to allocate specific sources of a trust's taxable income to its beneficiaries. In the CRA's view, an express provision is required. In CRA document no. 2004-0093661E5 (September 30, 2005), the CRA suggested that the taxable and non-taxable portions of a capital gain can be paid to different beneficiaries—an income beneficiary and a capital beneficiary—only if the trust's terms expressly permit it to do so. The trustee's broad discretion to determine what constitutes income and capital for trust-law purposes is not sufficient. In CRA document no. 2016-0634921C6 (June 10, 2016), the CRA said that trustees cannot rely on a general power to encroach on capital in order to characterize a taxable capital gain that arose from a deemed disposition in a trust payable to a capital beneficiary. The trust indenture must explicitly allow the payment of this deemed taxable capital gain or define "income" for trust purposes as including income as determined under the Act. The CRA was also of the view that, absent a specific power to do otherwise, multiple sources of income of an estate must be "distributed proportionately, according to each beneficiary's share" (CRA document no. 2005-0116041E5, January 16, 2006), making it impossible for the trustees to make different source allocations to different beneficiaries for income tax purposes.

This quick review reveals the CRA's reluctance to give effect to trustees' general powers but shows openness to targeted dispositions when the specific wording of a trust deed permits them. Would the CRA's view in TI 2019-0833061E5 have been the same if the trust indenture had granted the trustees the right to designate the safe income on hand to selected beneficiaries? Safe income on hand is not a theoretical concept; it represents real after-tax money paid to the trust. Dividends come out of safe income first in the order in which they are paid (see John R. Robertson, "Capital Gains Strips: A Revenue Canada Perspective on the Provisions of Section 55," in the 1981 Conference Report, at 84). This money can be singled out and allocated to a beneficiary. Such a designation by the trustees does not conflict with subsection 104(19), since it applies to "[a] portion of a taxable dividend received by a trust." The trustees should be able to identify the portion of the dividend corresponding to the safe income on hand and designate it in conformity with this subsection.

Is this sort of designation abusive? In my view, it is not. Obviously, the overall income tax payable in a situation like the example given in the TI could be higher if the corporate beneficiary receives only its proportionate share of the safe income instead of 100 percent of it. However, subsection 55(2) aims to tax any portion of a dividend exceeding the safe income on hand if the purpose tests in the subsection are met while safe income is circulated tax-free from one corporation to another. Allowing the corporate beneficiary the benefit of all the safe income while taxing the remaining portion in the personal beneficiary's hands would accomplish such a result.

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## New Trust Disclosure Rules: The Unfolding of the Propep Nightmare

New trust disclosure rules will be in place effective for taxation years ending on or after December 31, 2021. The rules will amend subsection 150(1.1) and add regulation 204.2(1). They will require trustees to report (among other things) the names of persons who are "beneficiaries" of the trust. This description will raise questions when persons have a contingent interest in the trust: are they considered beneficiaries for reporting purposes? The CRA appears to believe so, but we wonder whether this is a correct interpretation of the new legislation.

Most tax advisers are familiar with subparagraph 256(1.2)(f)(ii), whereby all beneficiaries of a discretionary family trust have deemed ownership of any shares of a corporation owned by the discretionary trust. This provision can lead to association issues—for example, when the settlor's children mature and perhaps establish their own corporations. Tax planners often try to manage this risk by using contingent interests. Contingent interests are also inherent in alter ego/joint partner trusts, since, by definition, there will be contingent interests that will vest after the death of the settlor.

Consider a trust indenture that includes a "conditional" clause whereby X can receive a distribution after a certain life milestone is achieved (for example, upon reaching a certain age or remaining married for a certain number of years). The intention of this conditional clause is to give a named person an interest in the trust upon the occurrence of some future event. In this example, X is not currently a beneficiary, but might be considered to be "beneficially interested" in the trust. Must his or her identity be disclosed under the new rules?

Regulation 204.2(1) will require disclosure of any person who is a "beneficiary" of the trust, but the Act does not define this term for the purpose of the regulation. Subsection 248(25) provides that certain persons are deemed to be "beneficially interested" in a trust, but it does not define "beneficiary" per se. The distinction between being a "beneficiary" and being "beneficially interested" was blurred by *Canada v. Propep Inc.* (2009 FCA 274), which said, in obiter, that a person should be regarded as a "beneficiary" throughout the Act if that person was "beneficially interested" in the trust. Hence, one might be forced to consider reporting beneficially interested persons under the new disclosure rule, assuming that the *Propep* obiter applies in this context—which, in our opinion, is questionable. The association rules operate at a point in time: that is, they do not consider a future tax event (in this case, future or contingent ownership rights). For the purposes of the association rules, identifying a person who has a beneficial interest as a "beneficiary" is complex. Although *Propep* is the only case that has so far addressed the association rules in the context of a beneficial interest, the ruling raises questions of statutory interpretation. For instance, the court says that "[a] person who has a contingent right to the capital or income of a trust is 'beneficially interested' for the purposes of the Act," but the association rules in section 256 do not specifically include the notion of a person who may be beneficially interested in the corporation. The *Propep* interpretation has been adopted by the CRA (see CRA document no. 2014-0538021C6, October 10, 2014).

Although the CRA took its position in the document with respect to the interpretation of subparagraph 55(5)(e)(ii), it may take a similar position when the issue arises under the new disclosure rules. It may be difficult for the CRA to apply this approach in some cases—for example, if the trust deed provides for the addition or deletion of persons as beneficiaries before the final distribution date of the trust.

The concept of "beneficially interested" has been examined elsewhere by the courts. For example, in *Sedona Networks Corporation v. Canada* (2007 FCA 169), in the context of "control" for the purposes of subsection 251(5), the court stated that a beneficial interest does not confer any right on the holder

of that interest to acquire shares. The rationale adopted in *Sedona* was that it was not Parliament's intention that subsection 248(25) apply to subsection 251(5) in the context of de jure control because the phrase "beneficial interest" is too broad in scope and too vague for it to apply to the concept of de jure control. In other words, if it was intended that the association rules in paragraph 256(1.2)(f) apply to persons who are "beneficially interested," the rules would have explicitly stated as much. (See also Jeffrey T. Love et al., "How Various Aggregation Rules Apply to Trusts," in the 2018 Conference Report, 28:1-79.)

In summary, the wording of new regulation 204.2(1) raises important issues of statutory interpretation. In the light of the CRA's adoption of the obiter in *Propep*, a trustee that chooses not to disclose the names of all persons beneficially interested in the trust runs the risk of being assessed penalties for inadequate disclosure. Advisers faced with this situation should consider recommending an appropriate amendment to the trust deed, or else choose to accept the risk of a potential associated-corporation assessment.

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## The Extreme Edge: Directors' Due Diligence Under the ETA

Directors' liability for unremitted GST/HST and the due diligence defence available under the ETA is a well-studied topic in the pages of industry journals and law firm blogs. The question less discussed, however, is how, in certain extreme cases, the law allows directors to avail themselves of a due diligence defence even when they know that their actions are likely to ensure that the corporation fails to meet its tax obligations. A recent case, *Penate v. The Queen* (2020 TCC 63), grappled with whether such a defence was available to a director/business owner whose employees (and herself) were subject to racial discrimination and sexual harassment by the corporation's clients. The TCC found that the appellant had been duly diligent, and it returned the assessment to the CRA for review and reconsideration.

### *Facts*

The appellant, Karla Penate, was the sole director and shareholder of Delphina Enterprises Ltd. Delphina was a roofing company incorporated in 2008 and was, according to Ms. Penate, the first female-run roofing company in Canada.

Delphina began to run into trouble in 2010, when the CRA seized about $8,000 from its bank account with respect to unremitted GST/HST. On the advice of Delphina's accountants, Ms. Penate hired a full-time bookkeeper, Dawn Eyben, who had 20 years' experience with bookkeeping for roofing companies. Delphina was engaged almost exclusively as a subcontractor for other construction operations, and part of Ms. Eyben's job was to attend job sites and obtain payments for Delphina's completed work when invoices went unpaid. Unfortunately, Ms. Eyben's efforts to collect on Delphina's accounts were constantly undermined by primary contractors' workers, who would regularly sexually harass her. In a series of typically grotesque occurrences, Ms. Penate was told on several occasions that Delphina would not receive payments for jobs unless she agreed to kiss, date, or marry various contractors or their employees. This behaviour was pervasive throughout Delphina's client base, and it severely hampered the firm's ability to collect on its accounts. The decision was made to stop Ms. Penate from attending construction sites and to have her replaced first by her brother, and then by a white male estimator after the brother and Delphina's roofing crews were subject to racial discrimination on the part of homeowners.

To further combat the harassment of her employees and herself, Ms. Penate explored the costs of changing Delphina's billing system (to allow the company to get paid at the job site) and doing its own advertising so that it could secure jobs on its own rather than as a subcontractor. Unfortunately, these solutions were found to cost thousands of dollars—money that Ms. Penate felt would be better applied to the deficient GST/HST remittances. Unable to collect on many accounts and pursued by CRA collections, Ms. Penate slashed Delphina's payroll, convincing some of her most loyal roofers to work for free until the accounts could be collected, and replacing Ms. Eyben with a university business student.

Things came to a head in 2013, when Ms. Penate attended another contractor's business to obtain payment for one of Delphina's jobs. She was told that "the contractor [would not] pay her because she would not agree to give him a French kiss." After this incident, Ms. Penate washed her hands of the business and, with the permission of the CRA collections officer with whom she had been working, sold Delphina to her brother. Ms. Penate then resigned as a director but stayed involved in the business, which culminated in a favourable collections agreement.

Unfortunately for Ms. Penate, the CRA collections officer was changed in 2014, and the new collections officer refused to abide by the agreement. The CRA then seized the corporate accounts, thereby putting Delphina out of business, before turning its attention to Ms. Penate for satisfaction of the firm's outstanding tax liabilities for the January 2011-December 2012 remittance period.

### The TCC Appeal

On appeal, the sole issue was whether Ms. Penate, as a director during the relevant period, was liable for Delphina's unremitted GST/HST, plus penalty and interest. Ms. Penate put forward a due diligence defence.

The court first examined the conditions for allowing a due diligence defence. ETA subsection 323(1) provides that the directors at the time that a corporation fails to remit GST/HST are jointly and severally liable with the corporation to pay those amounts and any related interest and penalties. Subsection 323(3) further provides that a director is not liable under subsection 323(1) if the director "exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances." The TCC relied on *Canada v. Buckingham* (2011 FCA 142). There, the court found that the standard of care in directors' due diligence cases should not disregard the individual circumstances of the director, and that "[w]hat is required is that the directors establish that they were specifically concerned with the tax remittances and that they exercised their duty of care, diligence and skill with a view to preventing a failure by the corporation to remit the concerned amounts."

The TCC then applied the decision in *Worrell v. The Queen* (1998 CanLII 288 (TCC)) and found that "in certain exceptional circumstances, a director may still establish the defence of due diligence where the business is carried on *knowing a failure to remit may be likely*" (emphasis added). The court concluded that the situation warranted the exceptional *Worrell* standard. Even though Ms. Penate knew that Delphina was not going to meet its tax obligations, her persistent effort to turn the business around and deal with the ongoing sexual harassment and discrimination meant that she met her standard of care and was duly diligent. The court looked favourably at Ms. Penate's decision to put Delphina's limited cash reserves toward the outstanding GST/HST remittances rather than propping up her business.

Ultimately, the court allowed the appeal, finding that there was no evidence that any GST/HST remittances were diverted to assist with business activities and that the "exceptional facts" in the case justified deploying the exceptional remedy from *Worrell*.

### Commentary

*Penate v. The Queen* is a high-water mark case. As a general procedure decision, it will open up the due diligence defence to situations where sexual harassment or racial discrimination is alleged. It will undoubtedly be an uphill battle for a director to make out a similar defence while also connecting those facts to the director's inability to prevent the default. Ms. Penate was successful, in part, because there was no evidence (or challenge in cross-examination) that contradicted her or her office manager's testimony: the court accepted it as "believable and credible." Tax professionals know how rare superstar witnesses are, and future directors are likely to have somewhat more difficulty on this front.

Also somewhat troubling, from the perspective of the fisc, was the lack of discussion of the corporation's ability to recover, via the "bad debts" provisions in ETA subsection 231(1), all of the GST/HST that the suppliers apparently refused to pay. If bad debts were claimed by the corporation, the GST/HST collectible would have been erased (leading one to wonder whether the GST/HST amounts at issue in this case were actually collected and used by Delphina for other business purposes). The court seems to have missed this point, although it did not seem to feature in the arguments of the CRA. Nonetheless, this point is troubling, since the focus of the case appears to have been on the business's inability to collect on its accounts. If all of the GST/HST was in fact recovered or recoverable by Delphina under ETA subsection 231(1), what stopped the director from remitting the GST/HST that was collected by the corporation? Although the sexual harassment and racial discrimination are clearly reprehensible actions, objectively they seem to be unrelated to this point. Time will tell how this interesting evolution of due diligence law develops.

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## Supporting Indigenous Canadian Entrepreneurs: Navigating Complex Tax Rules

*Authors' note: In the article that follows, we use the term "Indian" as it is used in the Indian Act (RSC 1985, c. I-5), and we use the term "status Indian" to mean "registered as an Indian in the Indian Register."*

Indigenous business owners face a challenging business environment. In addition to obstacles such as finding sources of financial support and securing digital access, Indigenous business owners must navigate complex tax rules that can be difficult to understand and are, in important ways, different from the tax rules applicable to non-Indigenous entrepreneurs.

In December 2017, the Indian Act was amended to address known sex-based inequities in Indian registration, and further amendments came into effect in August 2019. These amendments were in response to the Superior Court of Quebec's decision in *Descheneaux c. Canada (Procureur Général)* (2015 QCCS 3555). According to the Assembly of First Nations, these changes are likely to lead to a significant increase in new registrants on the Indian Register. They are also likely to lead to an increase in the number of people who are interested in understanding how the section 87 tax exemption works. Importantly, only status Indians qualify for tax exemption under section 87 of the Indian Act; Métis individuals do not.

According to Dr. Judith Sayers (Kekinusuqs), president of the Nuu-chah-nulth Tribal Council, one of the biggest misconceptions related to Indigenous business owners and the Canadian income tax system concerns the corporate form and the tax exemption in section 87 of the Indian Act. We have been advised by Sayers that because "a corporation is a separate legal body, it does not receive tax exemption for income earned, or for products and services delivered to the reserve." A corporation is not entitled to tax-exempt status under the Indian Act. For status Indian business owners, this means that the form of business organization that is chosen may inadvertently create a liability for income tax that reduces after-tax net cash flows and, ultimately, lessens return on investment.

The achievement of tax-exempt status is not always the foremost goal of Indigenous businesses; it must be weighed against other factors, such as liability protection, in optimizing stakeholder value. Income tax is only one consideration in deciding the most advantageous form for a business organization. Advisers may need to consider different combinations of tax-planning strategies, such as the payment of wages to tax-exempt owner-managers.

Indigenous business owners face the same legal and administrative tax rules as other residents of Canada, except for those whose income is eligible for the section 87 tax exemption. The key criterion for eligibility is that the income be connected to a reserve.

Arthur Mercer, the president of Tseax Development Group Ltd. (a business consultant to Indigenous sectors), has said that "[c]onnecting factors [are] important to look at," but in some circumstances they "are not clearly understood." Many factors are to be considered in determining whether business income is connected to a reserve, including the location of revenue-generating activities, the location of the head office, the type and nature of work, and the location of customers. Generally, if your business is conducted off-reserve, your income will likely not be eligible for the section 87 tax exemption. That said, there are situations in which a business conducts its activity off-reserve but the owner or sole proprietor may still be tax-exempt on his or her business earnings. This situation was addressed in *Canada v. Dickie* (2014 FCA 40), where a sole proprietor resided and conducted the management of the business on a reserve, but substantially performed the work off the reserve. The FCA found that the respondent was tax-exempt on his business income.

A business operated by a status sole proprietor, not through a corporation or other structure, that generates income both on- and off-reserve may prorate the tax exemption under section 87; thus, a portion of the business's income is subject to tax and a portion of the income is exempt. Related business expenses will be allocated to determine the profit from on-reserve revenue-generating activities and off-reserve revenue-generating activities. Business expenses incurred to generate tax-exempt income are not deductible, so it is important to track expenses accurately.

It should be noted that on-reserve businesses that are considering expanding off-reserve should think of income tax as another cost of doing business and make their expansion decisions in the context of maximizing the after-tax return on investment. For example, one might consider expanding off-reserve if benefits such as an increased client base and larger sales volume outweigh the related income tax and other costs of expansion.

The rules governing the requirement for Indigenous business owners to pay and charge GST/HST are complex and depend in great measure on situational factors. Generally, status Indians do not pay GST/HST when goods are purchased on a reserve or when goods are delivered to a reserve by the vendor. Additionally, by and large, when services are performed completely on a reserve, status Indians do not pay GST/HST on those services.

Nonetheless, there are circumstances in which GST/HST does apply—for example, when a status Indian purchases goods off-reserve and brings the goods to a reserve using his or her own vehicle. Status Indians are also exempt from PST in certain circumstances; the exemption varies by province. The fact that liability for GST/HST and PST is situationally dependent further highlights the complexity of the tax environment in which Indigenous business owners operate.

Research conducted by the Canadian Council for Aboriginal Business shows that Indigenous business owners consult experts for advice. Changes in the legal and taxation environments represent an opportunity for tax professionals to assist Indigenous business owners in navigating the complex tax rules that apply to their businesses. Tax professionals who are, or who become, knowledgeable about Indigenous tax issues can help Indigenous entrepreneurs to achieve their business goals, thereby serving the public interest.

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## Economic Downturn: Seizure of Property or Settlement of Debt

As a result of the COVID-19 pandemic, many Canadian businesses are struggling to meet their cash flow requirements, including the servicing of their debt obligations. If a borrower is unable to meet its debt obligations, a creditor may take

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possession of the collateral or agree to forgive a portion of the debt. There are income tax considerations for the borrower from the transfer of the property to the creditor or the settlement of the debt. Section 79 governs the income tax implications that arise when a creditor has acquired property from a borrower as a consequence of the borrower's failure to repay any part of an amount owed under a debt obligation. Sections 80 to 80.04 govern the tax implications for the borrower upon a settlement of debt at an amount less than the outstanding principal balance.

The transfer of property by the borrower to the creditor is a disposition for tax purposes. Subsection 79(3) provides that the borrower's proceeds of disposition upon the surrender of property is essentially equal to the unpaid principal and accrued interest on the loan that relates to that property at that time. The disposition may result in a capital gain or recapture to the borrower. Such income may be offset by current-year losses, if any, and the carryforward of prior years' capital and non-capital losses, as applicable. A capital gain or recapture commonly occurs when the principal balance of the original loan was increased due to a refinancing by the borrower at a time when the value of the property exceeded its ACB. Therefore, when the creditor seizes the property, the deemed proceeds of disposition includes the increased principal amount due to the refinancing.

In certain circumstances, the borrower may repay all or a portion of the debt subsequent to the surrender of the property. Subsection 79(4) states that if the amount repaid is with respect to debt that has previously been included in the calculation of proceeds of disposition pursuant to subsection 79(3), the amount is deemed to be a repayment of assistance at that time in respect of the property. If the property is non-depreciable capital property, subsection 39(13) applies to deem the repayment to be a capital loss to the borrower. If the property is other property (other than eligible capital property and resource property), paragraph 20(1)(hh) applies to deem the repayment to be a deduction from business or property income.

On the other hand, the settlement of the debt for an amount below its unpaid principal results in an income inclusion under subsection 80(13). The income inclusion may be reduced or eliminated when the borrower has tax attributes and cost base in capital property (subsections 80(3) to 80(11)). The remaining unapplied amount is an income inclusion from business or property pursuant to paragraph 12(1)(z.3).

Subsection 61.3(1) provides a deduction in computing the borrower's income when the borrower is a corporation that is insolvent at the time of the debt settlement. The deduction is essentially equal to the income inclusion under subsection 80(13). However, the deduction is ground down if the borrower has assets in excess of liabilities and/or has distributed assets out of the corporation by way of a dividend during the 12-month period preceding the end of the borrower's taxation year.

The provisions in section 79 and sections 80-80.04 may apply to the same settlement. However, the formula in subsection 80(13) provides that the income resulting from the settlement of debt excludes any portion of the principal amount of the obligation that is included in the amount determined for A, B, C, or D in subsection 79(3) in respect of the borrower for the taxation year of the borrower that includes that time or for a preceding taxation year. In other words, section 79 takes precedence over the debt-forgiveness rules of section 80.

In summary, the debt-forgiveness provisions may be more beneficial to a borrower because of the borrower's ability to use tax attributes and cost base to reduce any income inclusion; section 79, in contrast, may result in a capital gain or recapture on the disposition of the property without any corresponding deductions. The borrower's adviser should consider which approach is more beneficial to the client before an unpaid creditor precipitates matters by initiating a foreclosure governed by section 79.

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